1997 Annual Report

Zi Corporation

Zi CORPORATION

CONNECT + COMMUNICATE

At Zi Corporation, our goal is to deliver language-enabled technology and products. In the information age, we can allow hundreds of millions of people who use ideographic languages to communicate easily and effectively in their own language. By connecting technology to language, Zi Corporation can bring language processing to the mass market. Language processing is a new category of software. It supports the characteristics of the ideographic languages in a manner that is culturally consistent with the language. This consideration is important to people literate in ideographic languages, such as Chinese, who need to use technology. Zi Corporation is a publicly traded company listed on The Nasdaq Stock Market[SM] ("ZICAF") and The Toronto Stock Exchange ("ZIC"). Zi Corporation markets its products and technology to government, business and education from offices in Beijing, Hong Kong, San Francisco and Calgary, Canada.

Annual General Meeting

The Annual General and Special Meeting of the Shareholders of Zi Corporation will take place at the Calgary Petroleum Club, Cardium A & B on Tuesday, June 2, 1998 at 2:00 p.m.

CHAIRMAN'S MESSAGE

TO OUR SHAREHOLDERS: The last year has been one of substantial progress for Zi as we built upon our vision to connect technology to ideographic languages. The task facing us as we began 1997 was to build a foundation for Zi and to position the Company for future success. I believe that, in the last twelve months, we have taken significant steps to achieve this goal and so move the Company forward.

In the area of research and development, December 1997 saw a major milestone for the Company with the full release of the Zi 8 Input technology. Zi 8 Input was the culmination of a substantial amount of linguistic research and software development. Zi 8 Input was developed in direct response to feedback solicited from both the technology community and relationships in China and Asia-Pacific. With the release of this new technology, Zi has offered strong evidence of its commitment to providing a genuine solution to the language barrier currently facing users of ideographic languages. Equally important, we firmly believe we now have the core technology needed to take our Company forward into the 21st century.

On the marketing and sales front, we worked to establish a widespread and diverse marketing and distribution network in the Asia-Pacific region. Nineteen ninety-seven saw Zi achieve its Wholly-Owned Foreign Enterprise status in China which allows us to market our products directly to the business, government and education sectors. Led by strong efforts from staff in both the Hong Kong and Beijing offices, Zi has worked to build viable distribution channels for our technology and products in the Asia-Pacific region. These concentrated efforts resulted in agreements with such companies as Apple, Compaq, Fujitsu, and Netscape and the establishment of an electronic distribution network through numerous Internet service providers.

Our vision of Zi technology being used in devices beyond the personal computer came one step closer in the fall of 1997 with the signing of a license agreement with Advanced RISC Machines (ARM). Through this agreement we have gained access to a valuable distribution network intended to place Zi technology in devices ranging from hand held computers to Internet capable TVs. Both ARM and Zi look forward with great anticipation to the benefits from this partnership.

The result of these efforts is that Zi is now a company positioned to move forward in 1998. We have begun a transition to the next level of maturity as a software company. In this newest phase we look for increasing adoption of our technology and greater revenue generation. The first milestone in this transition has already been attained with the signing of a license agreement with Ericsson Mobile Communications AB. Ericsson's decision to choose Zi technology for use in its products, most notably cellular phones, serves as a validation of both our technology and our vision.

Nineteen ninety-seven has been a year of challenges for both Zi and its shareholders as we worked to build a foundation for success. I would like to thank our shareholders for their support throughout this past year. It is my belief that we have now built a solid foundation upon which to grow and are positioned for success. In 1998 we at Zi are committed to realizing the potential of our technology and our Company.

Michael E. Lobsinger
Chairman of the Board and Chief Executive Officer

April 30, 1998

Zi8 INPUT

- *Works the way the language works*
- *Simple to learn, easy to use by both the novice and the expert*
- *Chinese language-enable devices from the desktop to the palmtop*

This statement is the basis for our new generation of Chinese language-enabling technology. By making technology work the way the Chinese language works, we can allow millions of people to communicate easily in their own language. Whether they use a personal computer (PC), a handheld PC, a network computer, a set top box for Internet TV, a two-way pager, or a cell phone, Zi 8 Input can make the input and processing of the Chinese language easier. Zi connects the technology to the language.

How does Zi make technology work the way the Chinese language works? First, we know that each Chinese character is generally written with a specific sequence of pen strokes. This sequence of pen strokes is taught to children in school. By organizing a selected set of strokes on the keys of a keyboard, we connect the pen stroke (writing) to the keystroke (typing). For example, on a standard computer keyboard Zi 8 Input uses the 8 keys on the "home row". On a standard cell phone, Zi 8 Input uses 8 keys on the cell phone's keypad. By connecting writing to typing, we make Zi 8 Input simple to learn for literate Chinese people.

Zi 8 Input is not only simple to learn, it's also easy to use. The basis for ease of use is Zi 8 Input's language processing capabilities. Language processing recognizes the differences in nature and structure of languages such as Chinese that use ideographs instead of an alphabet for writing. These differences make typing Chinese more difficult than typing an alphabetic language like English. Language processing starts by incorporating linguistic rules, word associations and dictionaries to make input of Chinese easier and faster.

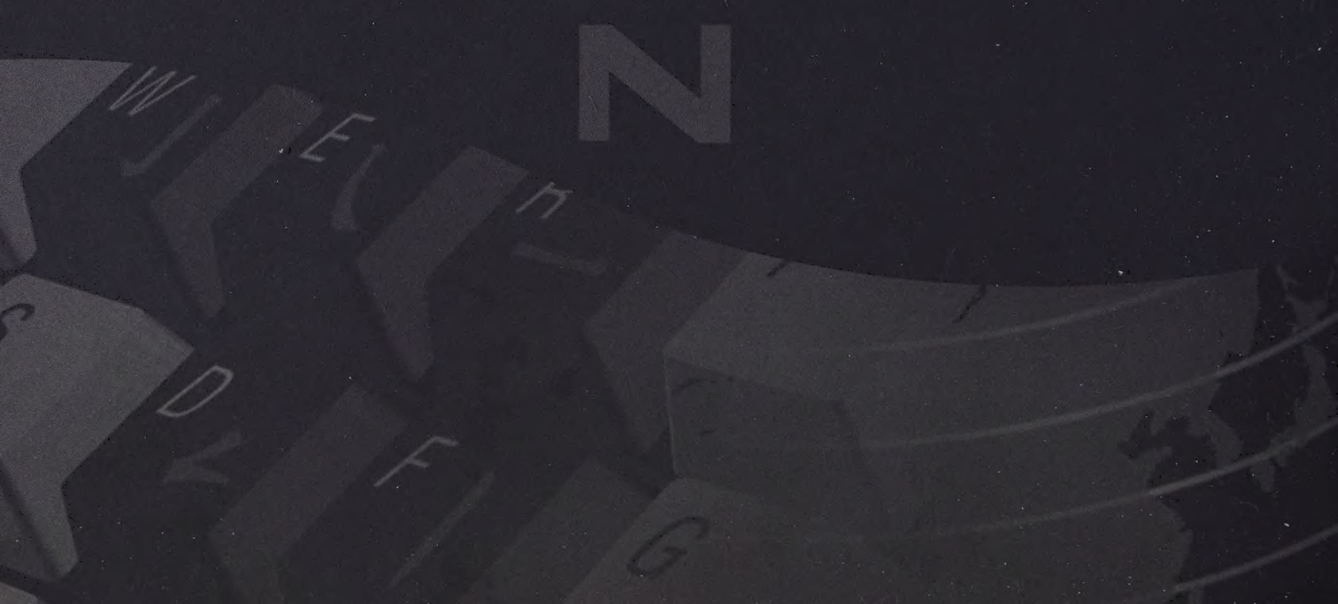
Zi 8 Input also meets the needs of both the novice and the expert. Once Chinese text is input, language processing allows applications to support editing, formatting, converting for regional usage, searching and encoding for data transmission in a manner that is consistent with the nature and structure of the Chinese language. Again, language processing works the way the language works.

Chinese people in business, government and education, whether at work or at home, can use electronic devices enabled with Zi 8 Input and its language processing capabilities to communicate more effectively in their own language.

Zi MAIL

4 GRADUATING FROM THE CLASSROOM TO THE WORLD

- *Chinese e-mail to communicate in your own language*
- *Automatically converts between Simplified and Traditional characters*
- *Zi 8 Input and language processing for the Internet*

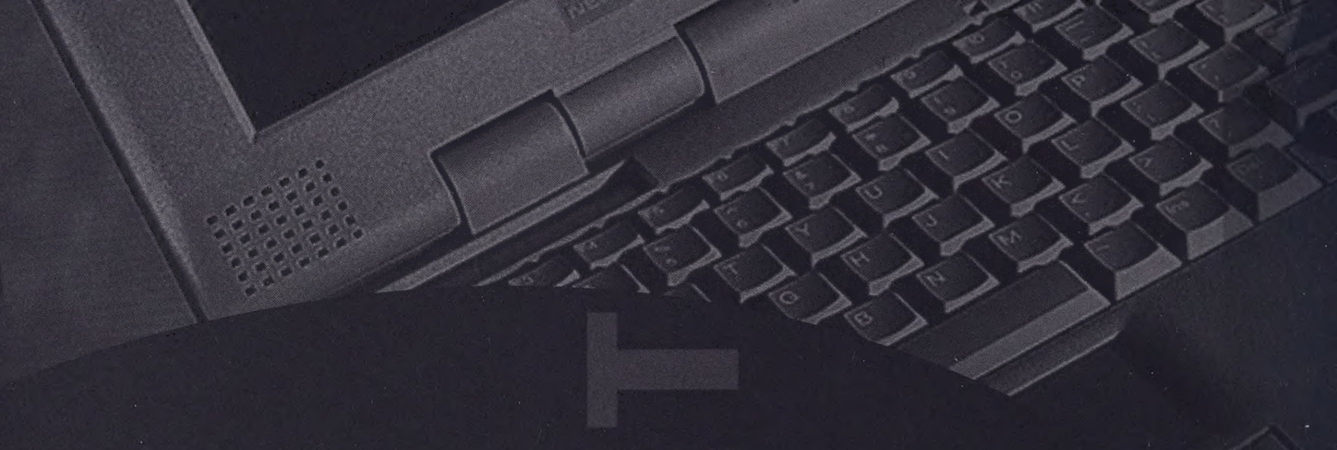


The growing integration of national economies is believed to have changed the way the world works. Electronic communication and in particular electronic mail (e-mail) as enabled by the Internet is a key aspect of the change in the way people work. An e-mail user can send and receive messages regionally, nationally or internationally. Many e-mail users in the Asia Pacific region need software that can send and receive messages in Simplified Chinese characters, Traditional Chinese characters and English.

Zi Mail can meet the requirements of these users. It includes Zi language processing capabilities that make the technology work the way the language works. Since Zi language processing includes Zi 8 Input, a Zi Mail user can quickly and easily compose messages using the "type as you write" capabilities of Zi 8 Input. If a Zi Mail user is exchanging messages with people across the Asia Pacific region, Zi Mail remembers preferences and automatically converts between Simplified and Traditional characters. For example, if a Zi Mail user composes a message in Beijing where Simplified characters are the standard, and sends the message to a colleague in Hong Kong where Traditional characters are the norm, the Zi Mail user in Hong Kong sees the message in Traditional characters when he or she reads the message. When the Zi Mail user in Hong Kong replies to his/her colleague in Beijing, the reply is automatically converted to Simplified characters. In addition to character conversion, Zi language processing converts words and idioms to reflect regional usage. For example, the characters for the word "taxi" are different in Beijing, Hong Kong and Taipei. These conversion features are one more aspect of Zi language processing.

As Chinese language e-mail software, Zi Mail not only supports the use of Chinese in the message, but also in the address book. The Chinese language features of Zi Mail together with the standard set of e-mail related features make Zi Mail a valuable tool for people working in business, government or education.

Zi Mail builds on the language processing capabilities of Zi 8 Input. Since Zi 8 Input applies the knowledge gained in learning how to write in the classroom, Zi Mail makes it easy to go from the classroom to the world with electronic communication that works the way the language works.



Zi INTERNET

- *Chinese language Internet Suite for e-mail and Web browsing*
- *Connect, communicate and access the Internet in your own language*
- *A one-stop solution for the Internet*

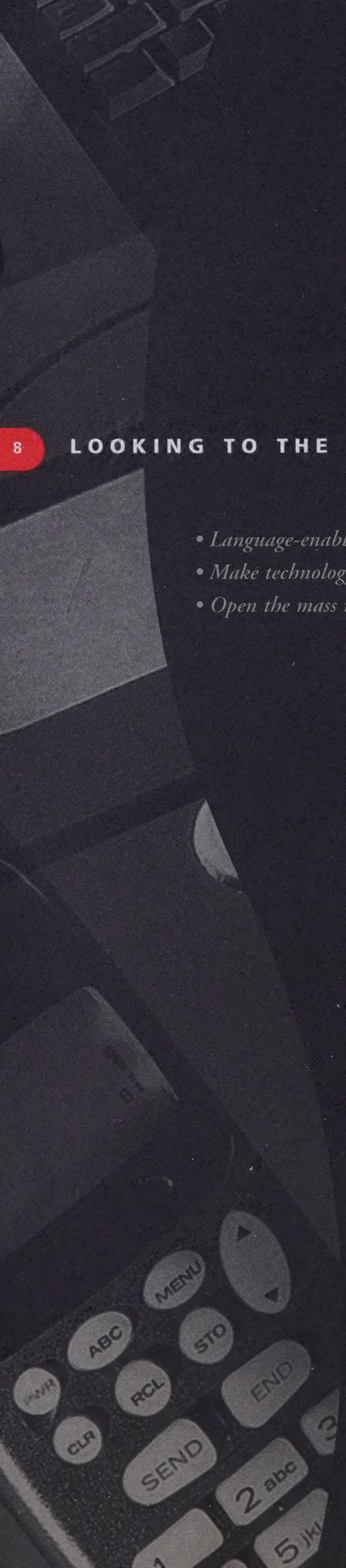
BRINGING LANGUAGE PROCESSING TO THE INTERNET

The number of Internet users in the Asia-Pacific region has increased significantly. Forecasts through the end of the century predict continued rapid growth. However, in comparison to other regions of the world, the percentage of businesses and homes in the Asia-Pacific region that uses the Internet is significantly lower. Factors such as language, cost, lack of infrastructure and government regulation accounted for most of the difference. Today, many of these factors are less significant, but the language barrier remains.

A report published in 1996 by the Gartner Group listed literacy as a barrier to the growth of the information technology market in the Asia Pacific region. One aspect of literacy is information technology literacy which historically requires some English language skills. However, the language of the majority of potential Internet users in the region is Chinese. When technology is effectively connected to the Chinese language, the Internet experience can change considerably. First, it becomes easier to learn how to use the Internet when you use the Internet in your own language. Second, it is simpler to view, create and publish Internet content in your own language. In an interview with *Internet World (HK)* magazine, Jerry Yang, co-founder of Yahoo, stated "The biggest barrier towards everyone (in China) using the Internet is the language issue."

Zi Internet Suite combines the language processing power of Zi 8 Input and Zi Mail with Netscape Navigator 4.0, the world-leading software for browsing the World Wide Web. Throughout the Asia-Pacific region people in business, government and education now have a tool to communicate and access information on the Internet. Zi language processing can go beyond the cosmetic aspects of "localizing" applications for language. When language processing is incorporated into applications like Zi Mail, the application works the way the language works. For example, it accommodates the special encoding required to send and receive Chinese language messages and documents over the Internet.

Zi Internet Suite can make the Internet experience more meaningful by allowing users to work in their own language. It provides a one-stop solution for Chinese Internet users and satisfies the needs of an expanding Asia Pacific market.



8 LOOKING TO THE FUTURE

- *Language-enable devices from the desktop to the palmtop*
- *Make technology work the way the language works*
- *Open the mass market in Asia Pacific*

Zi TECHNOLOGY

A cornerstone of Zi's corporate strategy is ubiquity – language processing everywhere and anywhere. Electronic devices that need to input, display, manage or communicate Chinese text can be enabled with Zi technology. In an interview with *USA Today*, George Wang, Director of IBM's Beijing Lab, stated: "(the input problem) has been a major inhibitor on the Chinese computer industry. Solve the input-output problem and the computer industry takes off".

Zi 8 Input provides Chinese language text input that is simple to learn and easy to use by both the novice and the expert. It can work on a wide variety of computers and information appliances. Examples of devices where Zi 8 Input can be applied include personal computers (PCs), handheld PCs, network computers, set top boxes for Internet TV, two-way pagers and cell phones. With Zi 8 Input and its language processing capabilities these devices can work the way the language works.

Although computers and information appliances are used in business, government and education, a consumer market is also opening up in the Asia Pacific region. The demand for devices such as PCs, set top boxes and cell phones is growing. Since Zi 8 Input is simple to learn, it provides an intuitive solution for the consumer market. Zi 8 Input provides keyboard or keypad input using the same pen stroke sequence that people learn in school to write characters. Through its language processing capabilities, Zi 8 Input is also easy to use. In addition, the ease of use features of Zi technology can be tailored to suit the capabilities of a particular device or the needs of its customers.

Because of its connection to the written Chinese language, Zi 8 Input can be implemented on specialized devices and applications targeted at the education market. There is a strong national and family commitment to education in the Asia Pacific region. Zi technology can be extended to a variety of applications in areas such as language literacy, computer literacy and teaching aids for school children of all ages.

The underlying design of Zi 8 Input and its language processing capabilities supports ideographic languages such as Chinese, Japanese and Korean. The initial focus of the Zi team is the Chinese language. With additional research and development, Zi 8 Input could be enhanced to support Japanese and Korean. Zi Corporation is looking to the future to better connect technology to language to allow millions of people in the Asia Pacific region to use technology in their own language.

OPERATIONS REVIEW

Special Note Regarding Forward Looking Statements

Certain statements in this "Management Discussion and Analysis – Operations Review" and "Management Discussion and Analysis – Financial Review" constitute "forward-looking statements" within the meaning of the *Private Securities Legislation Reform Act* of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company, or industry or market results, expressed or implied, to be materially different from any future results, performance, or achievements expressed or implied by such forward-looking statements. Such forward-looking statements herein are denoted and preceded as follows "→". The Management Discussion and Analysis is to be read in conjunction with the Company's audited financial statements for the year ended December 31, 1997, 1996 and 1995, and the Company's Form 20-F for the year ended December 31, 1997 filed with the U.S. Securities and Exchange Commission.

DEVELOPMENT

During 1997, the Company focused on the following development activities:

- In late 1997, the Company completed its new software product for the Chinese character based language, Zi 8 Input. Zi 8 Input is a stroke- and component-based input system that forms the foundation for the Company's current products and serves as a basis for future product development. Zi 8 Input follows the same stroke order that people learn in school to write characters. The Company also developed phonetic-based input methods which expand Zi 8's functionality.
- Zi Mail was developed and introduced in late 1996. Zi Mail is electronic mail software that enables users to send and receive e-mail messages over the internet in Traditional Chinese, Simplified Chinese and English. The product was commercially available in January 1997. In 1997, the Company expanded the functionality of Zi Mail for Windows during the year, and also developed it to operate on the Mac OS 8.0 operating system.
- The Company progressed in its development of a Chinese language Newsreader and an improved user interface for its products. The Newsreader is not currently commercially available.
- A system development kit was developed to allow third parties to develop applications using Zi technology. This kit is not generally distributed as it is intended for use only by certain licensee's of Zi technology.
- Netscape Navigator 4.0 for Chinese was integrated with Zi Mail and is included in the Company's commercially available, Zi Internet Suite.

The Company's dealings with officials of the Chinese government to date have provided management with positive feedback. The Chinese government is signaling a desire to do business with the rest of the world and is looking for technologies that can support such efforts. However, the Government of China also has a policy to support its local software industry. The Company has a local presence in China, with its offices in Beijing and Hong Kong. → The Company has built its products specifically for the Asian market, tries to be respectful of the Chinese culture, and believes it is in a position to assist in the evolution of technology in China. → This hopefully positions the Company to be viewed as supportive of the local software industry in China. In 1997 the Company was active in China as follows:

- The Company received a technical evaluation of the simplified Chinese character set for its Zi 8 Input product by the State Language Commission of China. This technical evaluation effectively endorses the Simplified Chinese linguistic elements of the Zi 8 product for use in China.
- Zi Input, the Company's 10 keystroke-based input software product, was endorsed by Guangdong Province, one of the wealthiest provinces in China.
- Guangdong Province's Computer Application & Development leading Group Office recommended and encouraged the use of 101 Chinese Input System (private labeled Zi Input distributed by a third party) by the Province's government departments, schools and newspaper media.
- The Company joined the Massachusetts Institute of Technology (MIT) as a Corporate Sponsor for the MIT China Educational Technology Initiative (MIT-CETI), where MIT students connected five high schools in Beijing, Shanghai and Xian, China to the Internet. The Company donated Zi Mail to each of the five Chinese high schools involved in the project.

→ Although the Company believes these factors position it positively with respect to political risk, there can be no assurances that governmental policies will not significantly disadvantage the Company's business.

→ The Company continued to have discussions with various OEMs with regard to integrating Zi Technology with electronic product applications ranging from handheld computers, set top boxes and telecommunications devices to bundling the Zi products with personal computers, network computers and network server technology.

During 1997, the Company took steps to establish distribution channels in Asia Pacific and North America for Zi Mail. → As Internet Service Providers (ISPs) serve the ideal demographics for Zi Mail, they can be an efficient distribution channel for reaching the individual user. In excess of 20 ISPs agreed to distribute Zi Mail to their customers. In addition, the Company signed distribution agreements with several Asia Pacific information technology companies to distribute Zi Mail.

During the year, the Company signed agreements with several distributors to market, distribute and sell Zi Mail. Zi Corporation supported these distributors with product promotion funding as these companies organized various marketing programs for the promotion of Zi Mail throughout China, the Asia Pacific Region and the North American Asian community. The industry publication *PC World Hong Kong* (March 1997 issue) selected Zi Mail as the best Chinese e-mail software on the market, ahead of products from Microsoft, Netscape and Alis Technologies.

In June, 1997, the Company announced a Joint Development Memorandum of Understanding with Apple Computer International Ltd. ("Apple") for future collaboration on Chinese language products for the Mac OS and Rhapsody, Apple's next generation operating system. → Apple is to assist the Company in the future to develop and market Chinese language products in the following areas: Internet and Intranet; word processing; education; and document processing and publishing. → The first stage of this alliance is a non-exclusive Software License Agreement where Apple is to bundle Zi Mail with Apple Macintosh personal

computers in China and Tawain. During 1997 the Company developed its Zi Mail product to operate on the Mac OS 8.0 operating system. As at December 31, 1997 Apple had not commenced shipping the product with its personal computers. No development is currently underway with other Apple products.

Throughout 1997, the Company continued discussions to secure agreements with key companies to embed Zi technology on a microprocessor for use in a variety of devices. The first of these discussions was concluded in September of 1997 when the Company announced that an agreement had been reached with Advanced RISC Machines (ARM) to market, distribute and sub-license the Company's Chinese character-based language processing technology. → This agreement is intended to render Zi technology available to ARM licensees, potential licensees and their OEM (Original Equipment Manufacturers) customers. → Through ARM's extensive marketing and distribution network, Zi technology is expected to become available to major OEMs worldwide for integration into small devices and appliances.

Zi Corporation continued to work to provide quality products for users of Chinese character-based languages worldwide. To this end, a joint marketing and distribution relationship was established with Netscape in 1997. The Company combined Netscape's Navigator 4.0 browser with the Company's Zi 8 Input and Zi Mail products to form an Internet package. In December 1997, the Company released the Zi Internet Suite which includes the Zi 8 Input, Zi Mail with Zi 8 inside and Netscape's Navigator 4.0 browser.

In October, 1997, the Company entered into an agreement with Stone RichSight Info. Tech. Co. Ltd. (SRS) to bundle the Company's Zi Mail 45-day trial version with SRS's CD-ROM packages for the Chinese market. → Under this agreement, SRS intends to bundle the Zi Mail 45-day trial version with its CD-ROM produced for all PC manufacturers and on SRS's RichWin 97 for Internet CD-ROM. → SRS has advised that they plan to distribute up to 150,000 copies per month into the Chinese market. → SRS also agreed to support the Company's marketing efforts by placing the Zi Corporation logo on all SRS promotional materials, product packaging and the product user's guides. Based in Beijing, SRS is a leading Chinese software development company. Some of the companies that SRS currently works with include Hewlett-Packard, IBM, Compaq, AT&T, Oracle and Microsoft. SRS's lead product set, the RichWin family of OS localization products, currently controls 35% and 95% of the market in China for Windows 3.1 and OS/2 respectively.

In 1997, the Company expanded its sales force and operations in Hong Kong and Beijing. During the second quarter of 1997, the Hong Kong operation commenced Internet Web page development services. These Internet Web page development services, as well as the Company's translation services, were discontinued in February 1998. In 1997, the Company reduced the number of personnel in both its Calgary and San Francisco operations. The North America consulting business acquired as part of the 1996 Solutions Source acquisition was discontinued in the second quarter of 1997.

The 17th annual Interbrand Corporate Name Change Survey selected Zi Corporation as the Best Corporate Name for 1997. Since Zi means "character" in Chinese, the results of the survey stated that "this distinctive and memorable name is the perfect identifier for a company that specialized in Chinese character language technologies".

DISCONTINUED TELECOMMUNICATIONS OPERATIONS

In March 1997, the Company sold its telecommunications business. The Company was no longer prepared to commit the financial resources required to continue to grow this business and did not consider it to be strategic to the Company's future.

OUTLOOK

In February, 1998, the Company acquired the rights to and ownership of the character-based language technology underlying three separate license agreements (known as the "Jiejing Licenses") of which the Company has been the exclusive worldwide licensee since November, 1993.

Consideration given by the Company for acquiring the rights to and ownership of the technology underlying the Jiejing Licenses was the accelerated release of 4,525,000 common shares of the Company previously issued and held in escrow. In November of 1993, in partial consideration for the Jiejing Licenses, the Company issued 5,000,000 common shares which were placed in escrow, subject to certain performance criteria for release. In return for the accelerated release of 4,525,000 of these common shares from escrow, the owners and licensors of the technology have:

- assigned all rights to and ownership of such technology, subject to the exclusion outlined below;
- agreed to the cancellation of 475,000 common shares of the Company previously issued and outstanding under the escrow terms and conditions;
- forgiven US$825,000 in license fees due and payable at December 31, 1997; and
- cancelled the Jiejing Licenses thus eliminating a cumulative US$22,500,000 in future annual license fees.

This acquisition is subject to one exclusion that had been in effect since the original license agreements were entered into. This exclusion applies to use of the "Jiejing Input System" in a proprietary-language teaching method used only to teach Mandarin Chinese. → The Company's management does not believe that this exclusion has been a limiting factor in the Company's ability to conduct its business operation in the past, nor is it expected to be so in the future.

In February, 1998 the Company entered into a licensing agreement with Ericcsson Mobile Communications AB ("Ericsson") to develop and integrate Zi Input technology into Ericsson products. → Ericsson initially intends to produce cellular phones that are capable of entering Chinese text. Ericsson is the first direct Original Equipment Manufacturer (OEM) to license Zi technology for use on a cellular phone. → This agreement includes licensing, engineering, development, royalty and maintenance fees payable by Ericsson to Zi Corporation. → The potential value of this agreement is expected to be between US$7 million and US$12 million.

→ The Company expects to continue investing in software development. → The Company plans to expand its input technology by adding increased character language processing functionality, integrate the Company's technology with Microsoft and Netscape applications, enrich the functionality of Zi Mail and the Zi Internet Suite and expand the system development kit for embedded applications.

FINANCIAL REVIEW

This discussion and analysis of financial condition and results of operations for the three years ended December 31, 1997, 1996 and 1995 should be read in conjunction with the consolidated financial statements and related notes in this Annual Report. The effects on net loss arising from differences in generally accepted accounting principles between Canada and United States are outlined in Note 14 to the consolidated financial statements.

RESULTS OF OPERATIONS

For the year ended December 31, 1997, the loss from continuing operations is $12.6 million compared with an operating loss of $9.5 million in 1996 and $4.7 million in 1995. The Company's telecommunications operations were sold in March, 1997 (see "Discontinued Operations"). Prior year comparative figures have

been restated to reflect this disposition. The Company operated at a loss throughout 1997. Decreased revenue, a provision for a legal judgement against the Company, currently under appeal, and increased costs for marketing, product promotion, personnel and bad debt expense contributed to the increased loss in 1997 compared to 1996.

In 1996, the Company increased its focus and investment in software operations. The Company operated at a loss throughout the year as marketing, personnel and software product development costs increased. The Company added personnel and opened new offices. The Company also acquired a consulting and software development company which added personnel costs and consulting revenue. During 1996 the Company reduced its translation operations.

In 1995, the Company continued to invest in the start-up of its software and translation operations. The Company operated at a loss throughout the year as it added personnel, leased facilities, incurred advertising and promotion costs and invested in software research and development.

OPERATIONS REVENUE

Operations Revenue by type and geographic segment is as follows:

		Software	Consulting	Total
1997	North America	$ 6,451	$ 208,273	$ 214,724
	Asia Pacific	789,571	306,678	1,096,249
	Total	**$ 796,022**	**$ 514,951**	**$ 1,310,973**
1996	North America	$ 5,714	$ 286,084	$ 291,798
	Asia Pacific	1,067,809	324,820	1,392,629
	Total	**$ 1,073,523**	**$ 610,904**	**$ 1,684,427**
1995	North America	$ 62,160	$ 9,531	$ 71,691
	Asia Pacific	220,455	286,158	506,613
	Total	**$ 282,615**	**$ 295,689**	**$ 578,304**

Revenues decreased 22% in 1997 compared to 1996. 1996 Software revenues included a US $500,000 one-time amount related to a specific contract. Consulting revenue decreased due to lesser translation revenue, as the Company decreased its focus on this service, and reduced North America consulting revenue as the Solutions Source consulting division, acquired in 1996, was discontinued in the second quarter of 1997. Partially offsetting these decreases was revenue from Asia Pacific Internet Web page development services, which commenced during the second quarter of 1997. Revenue specific to the Solutions Source consulting division was $139,505 in 1997 (1996 – $273,541). In February 1998, the Company ceased providing translation and Internet Web page development services as these had been operating at approximately breakeven throughout 1997 and were not considered strategic. Revenue specific to such services was $311,502 in 1997 (1996 – $337,363; 1995 – $295,689).

Revenues increased 190% in 1996 compared to 1995 as the Company increased software product sales, including US$500,000 related to product to be supplied to Tengtu International Corp. and increased consulting revenues through translation services revenue in Hong Kong and internet consulting services revenue in North America as a result of acquisition of Solutions Source Inc.

OPERATING COSTS & EXPENSES

1997 OPERATING COSTS

Total operating costs were $10.9 million, an increase of 36% from $8.0 million in 1996. Costs increased as the Company invested in marketing expenditures and product promotion for its distribution channels, increased expenditures were made in research and development, the Company added personnel, and a provision was made for a significant uncollectable account receivable. The primary cost increases in 1997 are as follows:

- Increased personnel costs as the Company added sales and software development professionals.
- Increased marketing costs including increased software production materials, marketing consulting expenses, travel expenditures and software distribution costs.
- $0.8 million related to product promotion costs. In 1997, the Company supported certain distributors of the Company's products with product promotion funding as these companies organized various marketing programs for the promotion of Zi Mail throughout China, the Asia Pacific Region and the North American Asian community.
- Bad debt provision of $0.7 million related to an amount due from Tengtu International Corp. which is considered to be uncollectable.
- Increased technology licensing costs.

During the second and third quarter of 1997 the Company reduced the number of personnel in both its Calgary and San Francisco operations. Costs for the San Francisco office included in 1997 operating costs of approximately $1.2 million (1996 – approximately $0.4 million). The Calgary office ceased providing its Solutions Source division consulting services. Costs specific to this consulting service included in 1997 operating costs were approximately $0.3 million (1996 – approximately $1.0 million). → Annual cost savings as a consequence of these reductions in the San Francisco and Calgary offices are anticipated to be approximately $1.2 million.

During 1997, the Company deferred development costs totaling $348,963 related to the development of Zi 8 Input. These costs are to be amortized over a three-year period commencing in December, 1997.

1996 OPERATING COSTS

Total operating costs were $8.0 million, an increase of 162% from $3.0 million in 1995. Costs increased significantly as the Company expanded its research and development, marketing and customer support operations in Hong Kong, San Francisco and Calgary, and commenced marketing and sales operations in Beijing. The primary cost increases in 1996 are as follows:

- Approximately 38 people were added to operations during the year, which resulted in a significant increase in personnel related costs.
- Approximately $1.0 million was invested in research and development for Zi Input Technology, which consisted primarily of personnel related costs.
- Facility rental costs increased with the addition of a Beijing office, a second Calgary office through the acquisition of Solutions Source, and the expansion of the San Francisco and Hong Kong offices.
- Travel costs and advertising and promotion costs increased significantly due to the increased emphasis on marketing of the Zi Internet Suite of products.
- Increased technology licensing costs.

GENERAL AND ADMINISTRATIVE COSTS

General and Administrative costs were $2.7 million in 1997, an increase of 42% over costs of $1.9 million in 1996. The increase is primarily attributable to increased personnel costs, professional fees and a provision of $486,770 for a legal judgement received against the Company. The Company was held liable to

Century Disposals Inc. for a Judgement wherein Century Disposals Inc. alleged that the Company should have sold the business assets of United Industrial Equipment Rentals Ltd. to Century Disposals Inc. These assets related to discontinued rental operations. The Company has successfully filed a Notice of Appeal and a stay of enforcement of this Judgement. The Company has not paid any Judgement amount to Century Disposals and as part of the stay application and appeal, the Company has secured the Judgement pursuant to an irrevocable letter of credit in the amount of $486,770. → There can be no assurance that the Company will prevail in its appeal.

General and Administrative costs of $1.9 million in 1996 increased 16% over costs of $1.6 million in 1995. Increased personnel costs, including a complete year of personnel added in 1995, and higher professional fees and shareholder reporting costs were the primary reasons for the cost increase.

DEPRECIATION AND AMORTIZATION

1997 depreciation and amortization expense of $0.4 million decreased 75% compared to $1.6 million in 1996. 1997 depreciation and amortization expense did not include any goodwill or license cost amortization as these intangible assets were fully amortized in 1996. Included in 1996 depreciation and amortization costs was $1.2 million of amortization expense related to goodwill and license cost.

1996 depreciation and amortization expense of $1.6 million increased 193% compared to $0.6 million in 1995. Included in 1996 is increased depreciation expense resulting from capital asset additions during the year, amortization of $0.8 million relating to capitalized technology license costs as the Company decreased the estimated useful life of such licenses, and $0.4 million write off of goodwill related to the acquisition of Solutions Source as it estimated that the potential net future cash flows from this business do not support the goodwill net carrying value at year end.

INTEREST AND OTHER INCOME

Interest and other income in 1997 of $149,645 (1996 – $338,655) decreased as interest income was lower due to less funds available for investment in the year.

Interest and other income in 1996 of $338,655 increased compared to $108,865 in the prior year, due to interest income earned from the increased funds available from investment proceeds received on issuance of common shares.

INTEREST EXPENSE

There was no interest expense in 1997 as the Company had no debt outstanding during the year. Interest expense of $11,600 in 1996 decreased compared to $146,261 in the prior year due to conversion of interest-bearing convertible notes and no shareholders' loans outstanding in the year. In the first half of 1995 $1.5 million of convertible notes were outstanding compared to $350,000 for the first half of 1996. In addition, in 1995 $0.7 million of shareholders' loans were outstanding for approximately six months.

INCOME TAX RECOVERY

As an international company subject to income tax rates in different countries, the Company's consolidated effective tax rate is the result of a blend of pre-tax profits and losses in different tax jurisdictions. Fluctuations in the tax rate occur as the blend changes and prior years' tax losses are able to be used. In 1997, 1996 and 1995, the Company realized losses for tax purposes, the benefit of which has not been reflected in these financial statements. → The Company has tax loss carry forwards of approximately $ 17.1 million which can be applied against future years' taxable income.

Profits earned by the Company's foreign subsidiaries are subject to the Canadian foreign affiliate rules. For Canadian companies there is no additional Canadian income tax on repatriated profits from active business operations in countries with which Canada has a tax treaty. → In contrast, US companies are taxed in the US on all repatriated active business profits and are only allowed a credit for taxes paid in foreign jurisdictions.

DISCONTINUED TELECOMMUNICATIONS OPERATIONS

The Company disposed of its telecommunications operations as it sold all of the shares of its wholly-owned subsidiary Miami International Gateway, Inc., (MIG) to a private Florida-based telecommunications company (the "Purchaser") pursuant to a Sale and Purchase Agreement dated March 7, 1997. This business was no longer considered strategic to the Company's future.

The Purchaser acquired all of the outstanding shares of MIG for consideration of US$1.5 million, assumption of all assets and liabilities and contingent cash consideration of US$1.0 million. The US$1.5 million is to be paid pursuant to a four year seven percent per annum Promissory Note. The Purchaser may discharge its obligations under the Promissory Note by paying US$150,000 within 90 days or by paying US$200,000 within 180 days, or by paying US$250,000 within 365 days. The contingent consideration of US$1.0 million is payable on March 7, 1999, if the telecommunication business acquired by the Purchaser achieves cumulative gross revenues of US$24.0 million for the 18-month period March 7, 1997 through September 7, 1998. To the best of the Company's knowledge, MIG has ceased all forms of operation and is insolvent. → The Company will not collect any proceeds from the Promissory Note or the contingent consideration. The Company will account for consideration only if cash is received.

The net loss in 1996 from the disposal of the telecommunications operations was $2,927,631 (net of nil tax) which includes the loss from operations for the period January 1, 1997 to March 7, 1997 of $1,832,303. The net loss from discontinued telecommunications operations for 1996 and 1995 was $8,495,451 and $3,908,041 respectively.

The majority of revenues earned by the Company up to December 31, 1996 had been from the telecommunications business, though the telecommunications business had never been operated profitably. → In addition, there could be contingent liabilities as the Company has been named in a lawsuit with respect to the disposition of MIG and there is no assurance that the Corporation may not be named in additional legal actions arising from the operations or sale of the telecommunications business.

DISCONTINUED RENTAL OPERATIONS

In 1994 the Company disposed of the rental assets and ceased operations of United Industrial Equipment Rentals Ltd., a wholly-owned subsidiary, as this business was no longer considered strategic to the Company's future. In 1996, proceeds of $500,000 were received on disposal of net assets (land and buildings), and a gain of $130,635 was realized. In 1995, the Company incurred a net loss of $170,842 primarily due to costs incurred on the final liquidation of rental equipment and related administration.

FINANCIAL CONDITION AND LIQUIDITY

CASH FLOW FROM OPERATIONS

During 1997, the Company had a negative cash flow from operations of $11.9 million compared to a negative cash flow of $11.8 million and $7.1 million in 1996 and 1995 respectively.

1997 Compared to 1996

The change during 1997 was primarily due to:

- $10.9 million in funds applied to operating costs.
- $2.7 million in funds applied to general and administrative expenses.
- A net cash inflow of $1.5 million due to a decrease in non-cash working capital.
- Cash outflows for discontinued telecommunications operations of $1.3 million. This outflow relates to the Company repaying a line of credit on behalf of Miami International Gateway, Inc. prior to the disposal of the telecommunications operations.

The change during 1996 was primarily due to:

- $8.0 million in funds applied to operating costs.
- $1.9 million of expenditures for administration.
- A net cash outflow of $623,855 due to an increase in non-cash working capital.
- Cash outflows for discontinued telecommunication operations of $3.3 million and discontinued rental operations of $18,368.

FINANCING ACTIVITIES

Cash was received or used by the Company for financing activities during 1997 and 1996 as follows:

- Cash inflows of $6.1 million from issuance of common shares of the Company pursuant to private placements and exercise of stock options and common share purchase warrants.

- Net cash inflows of $20.2 million from issuance of common shares of the Company pursuant to private placements and exercise of stock options and common share purchase warrants.

INVESTING ACTIVITIES

Cash has been used or was received by the Company for investing activities during 1997 and 1996 as follows:

- Cash outflows to purchase capital assets of $0.3 million to meet ongoing requirements. Cash outflows of $26,092 related to payments on capital lease obligations.
- Acquisition of a patent for $468,000. This patent was an existing United States patent dealing with the input of ideographic characters. → Management believes this patent's broad scope makes it an excellent addition to the Company's intellectual property portfolio.
- The Company deferred $0.4 million of costs during 1997 related to product development.

- The net acquisition cost of Solutions Source was $165,420. This is comprised of a cash payment of two dollars, cash acquired of $21,248 and a contingent liability of $186,666 which is unpaid and included in accrued liabilities at year end.
- Cash outflows to purchase capital assets of $0.8 million to meet expansion and ongoing requirements. Cash outflows of $31,132 related to payments on capital lease obligations.
- Cash outflows of $1.0 million for discontinued telecommunication operations relating to capital asset additions and customer base acquisitions.
- Cash inflows of discontinued rental operations of $0.5 million relating to the sale of land and buildings.

CASH REQUIREMENTS OUTLOOK

The Company has had negative cash flow from operations for each of the last three years. The Company's cash requirements over this period have been met through proceeds from issuance of common shares from private placements and exercise of common share purchase warrants, on the issuance of convertible notes and long-term debt and the disposal of capital assets of discontinued rental operations.

The Company's net cash position at the end of 1997 is $2.2 million. → Until revenue from operations increases, cash flow is expected to be negative.

→ The Company believes that cash requirements for 1998 will be funded partially through the exercise of outstanding common share purchase warrants which total US$6.3 million at December 31, 1997. The exercise of these warrants is dependent upon the market price of the common shares exceeding the exercise purchase price. → At year end, all of the potential cash inflow related to the exercise of these warrants is uncertain as the market price is below the exercise price.

→ The Company also believes that financing can be obtained through additional common share issuances pursuant to primary public offerings or private placements. In February, 1998 the Company raised additional funds through private placements to finance the continued growth of the business. The Company raised $500,000 through the issuance of convertible notes. The notes, which bear interest at 8% per annum, are due on March 4, 2000 and are convertible at the option of the holder into common shares during the term at $3.75 per share. $400,000 of such notes are secured by certain accounts receivable of the Company. In addition, the Company raised $2.8 million through the issuance of 851,000 Units. Each Unit consists of one common share and one-half common share purchase warrant, where one warrant is exercisable into one further common share upon payment of US $3.00 per share for a period of 12 months.

The Company has license fees payable of $1.1 million at December 31, 1997. Subsequent to year end, these license fees have been forgiven and need not be paid as a consequence of the acquisition by the Company of the technology underlying the related license agreements. As part of this transaction the licensors have forgiven the license fees due as at December 31,1997 and all future license fee amounts payable in the future.

→ The Company anticipates capital expenditures in 1997 of approximately $0.5 million related to computer equipment and facilities leasehold improvements. → These capital expenditures are to be funded from cash on hand and the cash inflows discussed above.

IMPACT OF INFLATION AND CHANGING PRICES

→ Inflation is not considered by management to be a major factor affecting continuing operations.

YEAR 2000 ISSUE

Many computer systems currently record years in a two digit format. Such computer systems will be unable to properly interpret dates beyond the year 1999, which could lead to business disruptions (the "Year 2000 Issue").

→ The Year 2000 Issue is not considered by management to be material to the Company for either its internal systems or software products and that related costs will not materially affect the financial position or operating results of the Company. However, there can be no assurance that the systems of other companies on which the Company's software products and internal computer systems rely will be timely converted, or a conversion that is incompatible with the Company's software products or internal computer systems, would not have a material adverse effect on the Company.

FOREIGN CURRENCY

The foreign operations of the Company are translated into Canadian dollars for financial statement presentation. → Consequently, movements in exchange rates may have a significant impact on financial results.

In the last three years the Company's revenues were primarily from non-Canadian denominated currency with revenue denominated primarily in Hong Kong and United States dollars. The Company's expenses are predominately denominated in United States, Hong Kong and Canadian dollars.

→ Based on the 1997 distribution of revenues and cash flows, a one cent change in the exchange rate between the Canadian and the US dollar or Hong Kong dollar, is estimated to affect the Company's financial results as follows:

(THOUSANDS OF CANADIAN DOLLARS)	Revenue	Cash Flow
US Dollar	$ 2	$ 9
Hong Kong Dollar	$ 50	$ 215

MANAGEMENT'S REPORT

The accompanying consolidated financial statements have been prepared by management and approved by the Board of Directors of the Company. Management is responsible for the information and representations contained in these financial statements and other sections of this Annual Report. The financial statements have been prepared in accordance with accounting principles generally accepted in Canada. In preparing these consolidated financial statements, management selects appropriate accounting policies and uses its judgement and best estimates to report events and transactions as they occur. Management has determined such amounts on a reasonable basis in order to ensure that the consolidated financial statements are presented fairly, in all material respects. Financial data included throughout this Annual Report is prepared on a basis consistent with that of the consolidated financial statements.

To assist management in discharging these responsibilities, the Company maintains a system of internal controls which are designed to provide reasonable assurance that its assets are safeguarded; that transactions are executed in accordance with management's authorization; and that the financial records form a reliable base for the preparation of accurate and timely financial information.

The external auditors conduct an independent audit of the consolidated financial statements in accordance with generally accepted auditing standards in order to express their opinion on these financial statements. Those standards require that the external auditors plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises this responsibility through the Audit Committee. This Committee meets with management and the external auditors to satisfy itself that management's responsibilities are properly discharged and to review the consolidated financial statements before they are presented to the Board of Directors for approval.

Michael E. Lobsinger
Chairman & Chief Executive Officer

Nairn L. Nerland
Chief Financial Officer

March 6, 1998

AUDITORS' REPORT

TO THE SHAREHOLDERS OF ZI CORPORATION: We have audited the consolidated balance sheets of Zi Corporation as at December 31, 1997, 1996 and 1995 and the consolidated statements of loss and deficit and changes in cash position for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in Canada. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts of disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1997, 1996 and 1995 and the results of its operations and the changes in its cash position for the years then ended in accordance with generally accepted accounting principles.

Deloitte & Touche

Deloitte & Touche
Chartered Accountants

Calgary, Alberta
March 6, 1998

CONSOLIDATED BALANCE SHEET

AS AT DECEMBER 31	1997	1996	1995
Assets			
Current Assets			
Cash	**$ 2,154,253**	$ 8,985,338	$ 2,096,983
Accounts receivable	**458,703**	1,413,028	3,314,675
Prepaid expenses	**92,526**	61,105	43,302
Assets relating to discontinued telecommunications operations (Note 9)	**–**	3,666,726	–
Capital assets held for sale (Note 9)	**–**	–	349,298
	2,705,482	14,126,197	5,804,258
Capital assets (Note 3)	**705,168**	827,933	1,534,967
Intangible assets (Note 4)	**468,000**	–	6,743,790
Deferred development costs (Note 1)	**339,270**	–	–
	$ 4,217,920	$ 14,954,130	$ 14,083,015
Liabilities			
Current Liabilities			
Accounts payable and accrued liabilities	**$ 1,870,016**	$ 1,574,435	$ 2,714,650
License fees payable (Notes 11 & 15)	**1,180,616**	717,052	375,200
Current portion of capital lease obligation (Note 3)	**11,275**	26,252	55,715
Convertible notes payable (Note 5)	**–**	–	350,000
Liabilities relating to discontinued telecommunications operations (Note 9)	**–**	5,041,698	–
Current portion of customer base acquisition costs payable (Note 2)	**–**	–	1,586,297
	3,061,907	7,359,437	5,081,862
Capital lease obligation (Note 3)	**–**	11,115	248,099
Customer base acquisition costs payable (Note 2)	**–**	–	954,800
	3,061,907	7,370,552	6,284,761
Shareholders' Equity			
Share capital (Note 7)	**13,725,030**	40,933,033	20,395,597
Deficit (Note 7)	**(12,569,017)**	(33,349,455)	(12,597,343)
	1,156,013	7,583,578	7,798,254
	$ 4,217,920	$ 14,954,130	$ 14,083,015

Approved by the Board:

Michael E. Lobsinger,
Director

Derrick R. Armstrong,
Director

CONSOLIDATED STATEMENT OF LOSS AND DEFICIT

YEAR ENDED DECEMBER 31	1997	1996	1995
Revenue	**$ 1,310,973**	$ 1,684,427	$ 578,304
Operating Costs and Expenses			
Operating costs	**10,925,195**	7,970,228	3,037,179
General and administrative	**2,684,900**	1,879,225	1,617,206
Depreciation and amortization	**419,540**	1,621,694	553,217
	14,029,635	11,471,147	5,207,602
Operating loss from continuing operations before the undernoted	**(12,718,662)**	(9,786,720)	(4,629,298)
Interest and other income	**149,645**	338,655	108,865
Interest expense	**–**	(11,600)	(146,261)
Loss before discontinued operations	**(12,569,017)**	(9,459,665)	(4,666,694)
Discontinued telecommunications operations (Note 9)	**–**	(11,423,082)	(3,908,041)
Discontinued rental operations (Note 9)	**–**	130,635	(170,842)
Net Loss	**(12,569,017)**	(20,752,112)	(8,745,577)
Deficit, beginning of year	**(33,349,455)**	(12,597,343)	(3,851,766)
Restatement (Note 7)	**33,349,455**	–	–
Deficit, end of year	**$(12,569,017)**	$(33,349,455)	$(12,597,343)
Loss per share before discontinued operations	**$ (0.474)**	$ (0.392)	$ (0.233)
Loss per share	**$ (0.474)**	$ (0.859)	$ (0.434)

CONSOLIDATED STATEMENT OF CHANGES IN CASH POSITION

YEAR ENDED DECEMBER 31	**1997**	1996	1995
NET INFLOW (OUTFLOW) OF CASH RELATED TO THE FOLLOWING ACTIVITIES:			
Operating Activities			
Loss before discontinued operations	**$(12,569,017)**	$ (9,459,665)	$ (4,666,694)
Add items not affecting cash:			
Depreciation and amortization	**419,540**	1,621,694	553,217
Funds applied to operations before discontinued operations	**(12,149,477)**	(7,837,971)	(4,113,477)
Decrease (increase) in non-cash working capital excluding discontinued operations	**1,545,056**	(623,855)	(13,165)
Cash flow applied to operations before discontinued operations	**(10,604,421)**	(8,461,826)	(4,126,642)
Cash flow applied to discontinued telecommunications operations	**(1,260,960)**	(3,318,489)	(2,999,456)
Cash flow applied to discontinued rental operations	**–**	(18,368)	(30,355)
	(11,865,381)	(11,798,683)	(7,156,453)
Financing Activities			
Proceeds from issuance of common shares	**6,141,452**	20,511,454	10,409,144
Financing fees	**–**	(324,018)	(200,000)
Issuance of common shares on note conversion	**–**	350,000	802,500
Repayment and conversion of convertible notes	**–**	(350,000)	(1,150,000)
Repayment of long-term debt related to discontinued rental operations	**–**	–	(991,091)
Repayment of shareholder loans	**–**	–	(720,229)
	6,141,452	20,187,436	8,150,324
Investing Activities			
Purchase of capital assets	**(264,101)**	(782,859)	(174,557)
Purchase of intangible asset	**(468,000)**	–	–
Deferred development costs	**(348,963)**	–	–
Payment of capital lease obligation related to capital assets	**(26,092)**	(31,132)	–
Acquisition of subsidiary net of cash acquired	**–**	(165,420)	–
Cash flow applied to discontinued telecommunications operations	**–**	(1,020,987)	(728,529)
Cash flow from discontinued rental operations	**–**	500,000	210,057
	(1,107,156)	(1,500,398)	(693,029)
Net Cash (Outflow) Inflow	**(6,831,085)**	6,888,355	300,842
Cash, beginning of year	**8,985,338**	2,096,983	1,796,141
Cash, end of year	**$ 2,154,253**	$ 8,985,338	$ 2,096,983

FOR THE YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

1. SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated financial statements are prepared using the historical cost basis in accordance with accounting principles generally accepted in Canada, which conform in all material respects with those in the United States, except as disclosed in Note 14.

Principle of Consolidation

These consolidated financial statements include the accounts of Zi Corporation (the "Company") and its wholly-owned subsidiaries. All material intercompany transactions have been eliminated.

Foreign Currency Translation

The accounts of the Company's integrated operations in foreign subsidiaries are translated into Canadian dollars using the temporal method whereby monetary items are translated at the rate of exchange in effect at the balance sheet date and non-monetary items are translated at applicable historical rates. Revenue and expense items are translated at the exchange rate in effect when each of the items is recognized. Depreciation and amortization are translated at the exchange rate used for those assets giving rise to the depreciation or amortization.

Measurement Uncertainty

The amounts recorded for allowance for doubtful accounts and accounts receivable write-offs, amortization period of intangible assets, amortization period of deferred costs, estimated useful life of capital assets, provisions for contingent liabilities, and revenue for translation and consulting services using the percentage of completion method are based on management's best estimates. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in estimates in future periods could be significant.

Capital Assets

The Company records capital assets at cost and provides for depreciation using the declining-balance method at the following annual rates:

Computer and office equipment	30%
Telecommunications equipment	20%

Leasehold improvements are recorded at cost and amortized over the remaining term of the lease.

Capital assets held for sale are recorded at the lower of cost or net realizable value.

The net cost of assets retired or otherwise disposed of and the related accumulated allowance for depreciation are eliminated from the accounts in the year of disposal and the resultant gain or loss is included in income at that time.

Intangible Assets

The Company records intangible assets at cost and provides for amortization using the straight-line method over the following periods:

Customer accounts	5 years
Goodwill	5 years
License agreements	3 years
Patent acquired	11 years
Deferred development costs	3 years

The Company periodically reviews the carrying value of its intangible assets wherever events or changes in circumstances indicate that the carrying value may not be recoverable. To the extent the estimated future cash inflows from such assets less estimated future cash outflows is less than the carrying amount, an impairment loss is recognized.

Effective January 1, 1996 the Company changed the estimated length of time that future benefits will be obtainable from the use of the license agreements. Accordingly, the period of amortization was changed from 10 to three years.

Revenue Recognition

Translation services revenue and revenue from consulting services are recognized using the percentage of completion method, whereby revenue is recorded at the estimated realizable value of work completed to date. Amounts received in advance are recorded as deferred revenue. Estimated losses on contracts are recognized when they become known.

Revenue from packaged software product sales is recognized when such software is shipped and accepted by the customer.

Revenue from and related to contractual software product sales is recognized upon the fulfillment of all significant obligations under the terms of such contracts.

Telecommunication services revenue is recognized in the period the customer utilizes the Company's service.

Research and Development Expenditures

Research costs are expensed as incurred. Development costs incurred prior to the establishment of the technological and financial feasibility of a project are expensed as incurred. Software development costs are capitalized when the technological and financial feasibility of a project is established. These costs are subsequently amortized using the straight-line method over the related product's estimated economic life. During 1997, $348,963 of software development costs were capitalized and are being amortized using the straight-line method over a period of three years. $9,693 of amortized software development costs are included in 1997 depreciation and amortization. As at December 31, 1997, $339,270 of capitalized software development costs remain.

Income Taxes

The Company accounts for income taxes using the deferral method of income tax allocation. Deferred income taxes result from claiming deductions for income tax purposes in amounts which differ from those charged in the financial statement accounts.

Leases

Leases are classified as capital or operating leases. A lease that transfers substantially all the benefits and risks incidental to ownership is classified as a capital lease. At inception, a capital lease is recorded as if it were an acquisition of an asset and the incurrence of an obligation. Assets recorded as capital leases are amortized on a basis consistent with that of accounting for capital assets.

Loss Per Common Share

Loss per common share is calculated using the weighted average number of common shares outstanding during the respective fiscal years. Fully diluted loss per share is not presented because the effect of the exercising of stock options, warrants and convertible notes is anti-dilutive.

2. ACQUISITIONS

All acquisitions have been accounted for using the purchase method with results from operations included in these financial statements from the date of acquisition. The acquisition identified in 2 (b) relates to discontinued telecommunications operations (see Note 9).

a) 1996 Acquisition – Solutions Source Inc.

On June 1, 1996 the Company acquired all the outstanding shares of Solutions Source Inc., an internet software development and consulting company, in exchange for assuming the net liabilities, giving nominal cash consideration of two dollars and contingent cash consideration of $186,666. The contingent cash consideration is payable dependent upon revenue targets specific to the business of Solutions Source as follows: $62,222 payable upon cumulative $500,000 revenue achievement; $62,222 payable upon cumulative $1,000,000 revenue achievement; $62,222 payable upon cumulative $1,500,000 revenue achievement. The goodwill of $426,266 was written off in 1996 and is included in depreciation and amortization expense of $1,621,694.

Net assets acquired		
Cash	$	21,248
Non-cash working capital		86,245
Capital assets		88,541
Goodwill		426,266
		622,300
Less current liabilities assumed		435,632
	$	186,668

b) 1995 Telecommunication Customer Base Acquisitions

In 1995 the Company expanded its telecommunications services by acquiring the customer base of three private businesses: July 1, 1995, Foneup Services Inc. and Telelink Services Inc.; August 1, 1995, Entra Communications Inc.; November 1, 1995, NetXchange Telecom Inc. The aggregate cost for these acquisitions, all of which were assigned to Intangible Assets – Customer Accounts, was cash consideration of $2,652,896. The acquisition cost for NetXchange Telecom Inc., originally estimated at $2,305,000 was contingent upon the profitability and cash flow of the acquired customer base, over a 20-month period from the date of acquisition. At December 31, 1995 acquisition costs payable were $2,541,097 of which $1,586,297 was current. In 1996, the required profitability and cash flow were determined to be unattainable resulting in the reduction of the acquisition cost to $99,380. The Intangible Assets – Customer Accounts and Customer Base Acquisition Costs Payable were similarly reduced.

3. CAPITAL ASSETS

	Cost	Accumulated Depreciation	Net Book Value 1997	1996	1995
Computer and office equipment	$ 1,185,182	$ 575,379	**$ 609,803**	$ 717,900	$ 634,590
Leasehold improvements	410,220	314,855	**95,365**	110,033	18,783
Telecommunications equipment (Note 9)	–	–	–	–	881,594
	$ 1,331,300	$ 503,367	**$ 705,168**	$ 827,933	$ 1,534,967

Included in computer and office equipment are assets under capital lease totaling $68,500 (1996 – $68,500 and 1995 – nil) and accumulated depreciation of $43,529 (1996 – $31,133 and 1995 – nil). Future minimum lease payments related to the capital lease obligation for 1998 is $11,275.

Included in telecommunications equipment for 1995 are assets under capital lease totaling $339,000 and accumulated depreciation of $45,200. There are no future minimum lease payments related to this capital lease obligation as the telecommunications equipment was disposed of in 1997 (see Note 9).

4. INTANGIBLE ASSETS

	Cost	Accumulated Depreciation	Net Book Value 1997	1996	1995
Patent acquired	$ 468,000	$ –	**$ 468,000**	$ –	$ –
License agreements	1,031,134	1,031,134	–	–	821,741
Pre-operating expenses	424,420	424,420	–	–	–
Goodwill	426,266	426,266	–	–	–
Customer accounts (Note 9)	–	–	–	–	5,922,049
	$ 2,349,820	$ 1,881,820	**$ 468,000**	$ –	$ 6,743,790

5. CONVERTIBLE NOTES PAYABLE

On May 15, 1994, the Company received $1,500,000 through the issuance of unsecured convertible notes. The notes, which bear interest at 8% per annum, were due on May 15, 1995 and were convertible at the option of the holder into common shares within one year at prices of $3.75 per share for 367,876 shares and $4.40 per share for 27,386 shares.

In 1995, holders of $867,500 of these notes agreed to extend the conversion and payment dates of the notes to May 15, 1996 at an interest rate of 10%. Subsequent to the extension agreement, $350,000 and $802,500 of these notes were converted to common shares in 1996 and 1995 respectively. In 1995, the Company repaid $347,500 of these notes. Interest on convertible notes in 1997 was nil (1996 – $11,600; 1995 – $83,000).

6. DEBT

During 1996, the Company was issued a US$1,000,000 Line of Credit with Citibank, F.S.B. on behalf of Miami International Gateway, Inc. Interest was calculated at the fluctuating rate of one percent over the Citibank base rate and payable monthly. The line of credit was secured by the U.S. dollar cash account. At December 31, 1996, the Line of Credit was fully utilized (see Note 9). Subsequent to December 31, 1996, the Line of Credit was fully repaid by cash on hand prior to the disposal of the telecommunications operations.

Interest on long-term debt in the year was nil (1996 – nil; 1995 – $60,000).

7. SHARE CAPITAL

	Number of Shares	Amount
Authorized:		
Unlimited number of common shares		
Unlimited number of Class A, 9% convertible, preferred shares		
Issued, Common Shares:		
Balance, December 31, 1994	18,784,500	$ 9,383,953
Issued on exercise of stock options	625,000	1,356,250
Issued on exercise of warrants	937,317	5,052,894
Issued on conversion of notes payable (Note 5)	209,250	802,500
Issued under private placements	1,333,334	3,800,000
Balance, December 31, 1995	21,889,401	20,395,597
Issued on exercise of stock options	673,000	2,430,000
Issued on exercise of warrants	1,476,667	7,100,002
Issued on conversion of notes payable (Note 5)	93,333	350,000
Issued under private placements	1,592,900	10,657,434
Balance, December 31, 1996	25,725,301	40,933,033
Issued on exercise of stock options	135,000	231,250
Issued on exercise of warrants	83,334	375,003
Issued under private placements	1,683,982	5,535,199
Restatement *	–	(33,349,455)
Balance, December 31, 1997	**27,627,617**	**$ 13,725,030**

* As a result of the passing of a special resolution by shareholders at the Annual General and Special Meeting held June 19, 1997, the stated capital of the Company was reduced by its December 31, 1996 deficit of $33,349,455.

Share Purchase Warrants

At December 31, 1997, the following share purchase warrants, issued in connection with private placements, were outstanding:

Warrants	Common Shares	Conversion Price Per common share	Expiry Date
1,136,363	1,136,363	US$3.00	November 30, 1998
547,619	547,619	US$5.25	June 19, 1999

Stock Options

At December 31, 1997, the Company maintained a Stock Option Plan for all directors, officers, employees and consultants of the Company.

Under the terms of the Stock Option Plan, options may be granted at the discretion of the Board of Directors. The option price equals the closing price of the Company's shares on the day preceding the date of grant. The options are not assignable, vest at the discretion of the Board of Directors, and expire, at maximum, after the 10th anniversary of the date of grant.

The purchase price of common shares under options outstanding as at December 31, 1997, range from $0.15 to $8.75. The Company has 464,200 remaining shares reserved for possible future allocations under the Stock Option Plan.

Changes in the number of common shares under option during the three years ended December 31, 1997, are summarized as follows:

	1997	1996	1995
Outstanding, beginning of year	**3,818,600**	2,603,000	2,025,000
Granted	**1,334,000**	2,076,600	1,278,000
Cancelled	**(909,800)**	(188,000)	(75,000)
Exercised	**(135,000)**	(673,000)	(625,000)
Outstanding, end of year	**4,107,800**	3,818,600	2,603,000

Escrowed Shares

Pursuant to policies of the Alberta Securities Commission and the Alberta Stock Exchange, certain issued common shares were held in escrow. At December 31, 1997, 5,000,000 (1996 – 5,000,000; 1995 – 7,135,800) common shares were held in escrow. Subsequent to December 31, 1997, 4,525,000 common shares were released from escrow and 475,000 common shares were cancelled and returned to treasury (see Note 15).

8. INCOME TAXES

Substantially all of the Company's activities are carried out through operating subsidiaries in a number of countries. The income tax effect of operations depends on the tax legislation in each country and operating results of each subsidiary and the parent company.

The provision for income taxes reflects an effective tax rate which differs from the corporate tax rate for the following reasons:

	1997	1996	1995
Combined basic Canadian federal and provincial income tax rate	**44%**	44%	44%
Expected combined Canadian federal and provincial tax recovery based on above rates	**$ 5,530,367**	$ 4,162,000	$ 2,053,000
Differences in foreign statutory tax rates	**(1,910,000)**	(1,675,000)	(715,000)
Permanent differences	**(115,367)**	628,000	(246,000)
Unrecognized recoveries on losses	**(3,505,000)**	(3,145,000)	(1,092,000)
Consolidated income tax	**$ –**	$ –	$ –

At December 31, 1997, the Company had losses for income tax purposes available to reduce future taxable income in Canada and various foreign jurisdictions of $6.8 million and $10.3 million respectively. Under current Canadian and foreign income tax legislation, the losses do not expire before 1999.

9. DISCONTINUED OPERATIONS

a) Discontinued Telecommunications Operations

A formal plan of disposal for the telecommunications operations was approved by the Board of Directors of the Company in December 1996. In 1997, the Company disposed of its telecommunications operations as it sold all of the shares of its wholly-owned subsidiary, Miami International Gateway, Inc. (MIG), to Custom Technology Communication, a private Florida-based telecommunications company (the "Purchaser") pursuant to a Sale and Purchase Agreement dated March 7, 1997. The principal of the Purchaser was an officer of the Company. Effective as of the closing, this officer ceased to be associated with the Company or any of its subsidiaries.

The Purchaser acquired all of the outstanding shares of MIG for consideration of US$1.5 million and contingent cash consideration of US$1.0 million. The US$1.5 million is to be paid pursuant to a four year, seven percent per annum Promissory Note. The contingent consideration of US$1.0 million is payable on March 7, 1999, if the telecommunications business acquired by the Purchaser achieves cumulative gross revenues of US$24.0 million for the 18-month period March 7, 1997 through September 7, 1998. To the best of the Company's knowledge, MIG is insolvent and no longer conducts any form of operations. The Company will not collect any consideration.

The net loss in 1996 from the disposal of the telecommunications operations was $2,927,631 (net of nil tax) which includes the loss from operations from January 1, 1997 to March 7, 1997 of $1,832,303.

	1997	1996	1995
Net loss from discontinued telecommunications operations for the year ended December 31 (net of nil tax)	**$ –**	$ 8,495,451	$ 3,908,041
Telecommunications operations revenue	**$ –**	$ 15,638,601	$ 9,442,864

The following net assets and liabilities as at December 31, 1996 related to the discontinued telecommunications operations:

Net Assets	
Cash	$ 86,655
Non-cash working capital	1,966,444
Capital assets	1,506,045
Customer Accounts	107,582
	$ 3,666,726
Net Liabilities	
Bank indebtedness	$ 1,371,300
Accounts payable and accrued liabilities	3,670,398
	$ 5,041,698

b) Discontinued Rental Operations

Operations of United Industrial Equipment Rentals Ltd. were discontinued in 1994.

In 1996, proceeds of $500,000 were received on the disposal of net assets (land and buildings) of the discontinued rental operations, which were presented as capital assets held for sale of $349,298 at December 31, 1995, and a gain of $130,635 (net of taxes of nil) was realized. In 1995, an operating loss of $170,842 (net of tax recovery of $102,000) was incurred on the wind-up of operations and proceeds of $210,057 were received on disposal of net assets (land and building).

10. RELATED PARTY TRANSACTIONS

The following table outlines the Company's related party transactions:

	1997	1996	1995
Management fees paid to a company owned by a director	**$ 282,839**	$ 311,655	$ 142,800
Legal services provided by a law firm in which a director is a partner	**$ 45,839**	$ 88,446	$ 73,200
License fees to two companies owned by shareholders (1997 and 1996); director and consultant/shareholder (1995)	**$ 1,180,616**	$ 483,980	$ 475,000
Interest income related to an officer loan	**$ 9,933**	–	–
Consulting services provided by two companies in which a shareholder and a director are principals (1996); a shareholder is a principal (1995)	**$ –**	$ 145,726	$ 197,140
Interest paid to two shareholders/ directors related to shareholder loans	**$ –**	$ –	$ 46,244
Interest to two companies owned by a director and a consultant/shareholder related to license fees	**$ –**	$ –	$ 21,068

These transactions are in the normal course of operations and are measured at an exchange value which approximates the arms-length equivalent as with any third party.

At the year-end, the amounts due to (from) related parties are as follows:

	1997	1996	1995
Due to law firm in which a director is a partner	**$ 14,628**	$ 22,006	$ 9,300
License fees due to two companies owned by shareholders (1997 and 1996); director and consultant/shareholder (1995)	**$ 1,180,616**	$ 483,980	$ 375,200
Due from officers (1997 and 1996); to company in which consultant/shareholder is principal (1995)	**$ (103,677)**	$ (124,209)	$ 72,800
Due to two companies in which two directors are principals	**$ –**	$ 34,704	$ –

11. COMMITMENTS

The Company rents premises and equipment under operating leases which expire at various dates up to April, 2002. Annual rentals under these leases for each of the next five years are as follows:

1998	$ 1,156,500
1999	$ 1,110,000
2000	$ 247,000
2001	$ 168,000
2002	$ 56,000

Effective November 12, 1993, the Company entered into three separate licensing agreements relating to the worldwide rights of certain Chinese character-based software technologies. Annual fees for these license agreements are US$1,125,000 per annum for each of the years 1998 through 2018. Subsequent to December 31, 1997, these licensing agreements were cancelled (see Note 15).

12. CONTINGENCIES

The Company has been named as a defendant in a lawsuit arising in the normal course of its Chinese character-based technology business, in a lawsuit with respect to the acquisition of certain customer accounts related to discontinued telecommunications operations, and a lawsuit with respect to the disposal of discontinued telecommunications operations. It is the opinion of management that these lawsuits will not be successful and the final determination of such claims will not materially affect the financial position or operating results of the Company.

13. SEGMENTED INFORMATION

The Company operates in one distinct industry with two reportable geographic segments:

		Revenue Software	Revenue Consulting	Revenue Total	Operating Loss	Identifiable Assets
1997	North America	**$ 6,451**	**$ 208,273**	**$ 214,724**	**$ 6,337,966**	**$ 2,998,545**
	Asia Pacific	**789,571**	**306,678**	**1,096,249**	**6,380,696**	**1,219,375**
	Total	**$ 796,022**	**$ 514,951**	**$ 1,310,973**	**$12,718,662**	**$ 4,217,920**
1996	North America	$ 5,714	$ 286,084	$ 291,798	$ 5,310,287	$ 9,683,501
	Asia Pacific	1,067,809	324,820	1,392,629	4,476,433	1,603,903
	Total	$ 1,073,523	$ 610,904	$ 1,684,427	$ 9,786,720	$11,287,404
1995	North America	$ 62,160	$ 9,531	$ 71,691	$ 2,679,646	$ 1,784,749
	Asia Pacific	220,455	286,158	506,613	1,949,652	1,356,884
	Total	$ 282,615	$ 295,689	$ 578,304	$ 4,629,298	$ 3,141,633

One customer, relating to Asia Pacific software sales, accounted for 16% of the Company's 1997 revenue. One customer, relating to Asia Pacific software sales, accounted for 41% of the Company's 1996 revenue.

During the years ended December 31, 1996 and 1995, the Company operated in two distinct industry segments, Chinese character-based language processing technologies and telecommunications services. Telecommunications services were discontinued effective December 31, 1996 and disposed of in 1997 (see Note 9).

14. UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The consolidated financial statements, prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"), conform with those generally accepted in the United States ("U.S. GAAP"), in all material respects, except:

a) Consolidated Statement of Loss and Deficit

	1997	1996	1995
Loss before discontinued operations pursuant to U.S. GAAP	**$ 12,569,017**	$ 9,459,665	$ 4,666,694
Net loss pursuant to U.S. GAAP	**$ 12,569,017**	$ 20,752,112	$ 8,745,577
Loss per share before discontinued operations pursuant to U.S. GAAP	**$ 0.584**	$ 0.494	$ 0.310
Loss per share pursuant to U.S. GAAP	**$ 0.584**	$ 1.083	$ 0.581

Pursuant to Canadian GAAP, common shares held in escrow which are subject to future performance level criteria are included as outstanding shares in the calculation of loss per share. U.S. GAAP requires that these shares (5,000,000 in 1997, 1996 and 1995), be excluded from the calculation of basic loss per share.

Pursuant to Canadian GAAP, certain 1997 market promotion costs totaling $832,465, reported as part of Operating costs, is directly related to $578,483 recorded as Revenue to the Company. U.S. GAAP requires that such revenue be recorded on a net basis as an offset to the related costs. Therefore, pursuant to U.S. GAAP, 1997 Revenues and Operating costs would be reported as $732,490 and $10,346,712 respectively. This reclassification has no effect on Net Loss or Loss per share for 1997. The 1997 amounts reportable under U.S. GAAP in this note are unchanged from the amount presented.

b) Consolidated Balance Sheet

Pursuant to Canadian GAAP, the December 31, 1997 stated capital of the Company was reduced by its December 31, 1996 deficit of $33,349,455. U.S. GAAP does not allow for such restatement. Therefore, pursuant to U.S. GAAP, December 31, 1997 Share capital and Deficit would be reported as $47,074,485 and $45,918,472 respectively. This reclassification has no effect on net Shareholders' Equity as at December 31, 1997.

c) Consolidated Statement of Changes in Cash Position (SCCP)

Pursuant to Canadian GAAP, SCCP requires disclosure of non-cash transactions. The reduction of debt through the conversion of convertible notes and the subsequent issuance of common shares for $350,000 and $802,500 in 1996 and 1995 respectively were non-cash transactions. U.S. GAAP requires that non-cash transactions be excluded from SCCP disclosure. The exclusion of the non-cash transactions has no net effect and the total financing activities for 1996 and 1995 reportable under U.S. and Canadian GAAP is unchanged from the amount presented on the SCCP.

15. SUBSEQUENT EVENTS

Subsequent to December 31, 1997, the Company entered into the following:

a) In February, 1998, the Company acquired the rights to and ownership of the character-based language technology underlying three separate license agreements (known as the "Jiejing Licenses") of which the Company has been the exclusive worldwide licensee since November, 1993.

Consideration given by the Company for acquiring the rights to and ownership of the technology underlying the Jiejing Licenses is the accelerated release of 4,525,000 common shares of the Company, previously issued and held in escrow. In November of 1993, in partial consideration for the Jiejing Licenses, the Company issued 5,000,000 common shares which were placed in escrow, subject to certain performance criteria for release. In return for the accelerated release of 4,525,000 of these common shares from escrow, the owners and licensors of the technology have:

i) assigned all rights to and ownership of such technology, subject to one exclusion;

ii) agreed to the cancellation of 475,000 common shares of the Company previously issued and outstanding under the escrow terms and conditions;

iii) forgiven US$825,000 in license fees due and payable as at December 31, 1997;

iv) cancelled the Jiejing Licenses thus eliminating a cumulative US$22,500,000 in future annual license fees.

b) In February, 1998 the Company raised additional funds through private placements to finance the continued growth of the business. The Company raised $500,000 through the issuance of convertible notes. The notes, which bear interest at 8% per annum, are due on March 4, 2000 and are convertible at the option of the holder into common shares during the term at $3.75 per share. $400,000 of such notes are secured by certain accounts receivable of the Company. In addition, the Company raised $2.8 million through the issuance of 851,000 Units. Each Unit consists of one common share and one-half common share purchase warrant, where one warrant is exercisable into one further common share upon payment of US$3.00 per share for a period of 12 months.

CORPORATE INFORMATION

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Simon X. Jiang
New York City, New York

Michael E. Lobsinger
Calgary, Alberta

Thompson MacDonald *
Calgary, Alberta

* *Member of the Audit Committee*

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Chief Executive Officer

Nairn L. Nerland
Chief Financial Officer

Derrick R. Armstrong
Corporate Secretary

Robert A. Blackshaw
Executive Vice President,
Business Development

Steve Corbett
Senior Vice President,
Sales & Special Projects

Wally Ritchie
Senior Vice President,
Software Product Development

Don Smallwood
Senior Vice President,
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Hongkong Bank

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AUDITORS

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SHARES LISTED AND SYMBOLS

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